



# Economic Update

Committee on the Budget • Majority Caucus  
U.S. House of Representatives  
Jim Nussle, *Chairman*

309 Cannon House Office Building  
Washington, DC 20515 (202) 226-7270  
Jim Bates, *Chief of Staff* • [www.budget.house.gov](http://www.budget.house.gov)

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## Sustained Expansion Provides Basis for FY 2006 Budget

The broad array of evidence points to the U.S. economy being in a sustained expansion with solid economic growth, increasing payrolls, low unemployment and low inflation – a marked improvement compared with conditions of 2 years ago. This revived economic outlook provides an important foundation for the upcoming review and adoption of policy proposals for the Federal budget as the Congressional Budget Office [CBO] and the Office of Management and Budget [OMB] will soon be releasing their updated projections for the Federal budget.

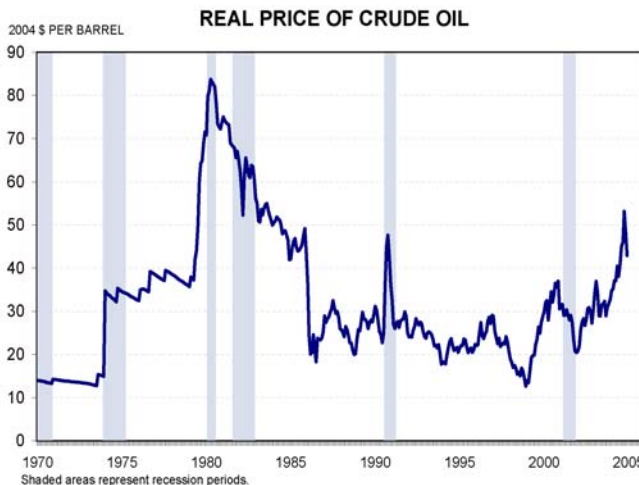
### Recent Data

- **Real GDP Growth:** Real gross domestic product [GDP] grew at a 4.0-percent annual rate in the third quarter of 2004 – matching the real growth rate over the past year. The gains of the past year were broad-based: real consumption spending rose 3.6 percent; real nonresidential fixed investment rose 10.1 percent; real residential investment rose 8.0 percent; and real Federal Government spending rose 4.8 percent (with real defense spending up 8.5 percent). Real state and local government spending remained flat over the past year. Net exports represented the only significant drag; net exports as a percentage of nominal GDP declined from -4.4 percent to -5.2 percent.
- **Jobs Growth:** December's 5.4-percent unemployment rate – down from 6.3 percent in June 2003 – is low by historical standards. Payroll employment increased by 157,000 jobs in December; jobs gains averaged 190,000 per month during all of 2004. Payroll employment has now increased for 16 straight months, and is up more than 2.6 million jobs over that period. Private forecasters expect the unemployment rate will continue to gradually decline and jobs growth is expected to average around 187,000 jobs per month during 2005 (see Blue Chip forecast below).
- **Consumption and Consumer Confidence:** Consumer confidence rose sharply in December and retail sales

surged 1.2 percent – pointing to strong growth in consumption spending in the fourth quarter. Retail sales were up 8.7 percent during 2004 – the strongest yearly gain in 5 years. Confidence and consumer sentiment are at levels consistent with a sustained expansion.

Crude oil and gasoline prices have declined somewhat following the sharp increases that occurred during much of 2004. The price of crude oil (West Texas Intermediate crude) rose from about \$33 per barrel at the beginning of 2004 to in excess of \$55 per barrel in late October. Since then, however, crude prices fell back to as low as \$42 per barrel. Similarly, gasoline prices rose from around \$1.50 per gallon at the beginning of 2004 to more than \$2 per gallon, but have since returned to below \$1.80 per gallon. Although crude oil prices increased recently, futures prices show declines to about \$42 per barrel over the next 2 years.

Prices continue to be volatile, but the declines of recent months, and the falling pattern for futures prices, help temper concerns that high oil and gasoline prices will have substantial adverse effects on the economy. In addition, in the historical perspective for real, inflation-adjusted prices, the increases of the past year were less dramatic than



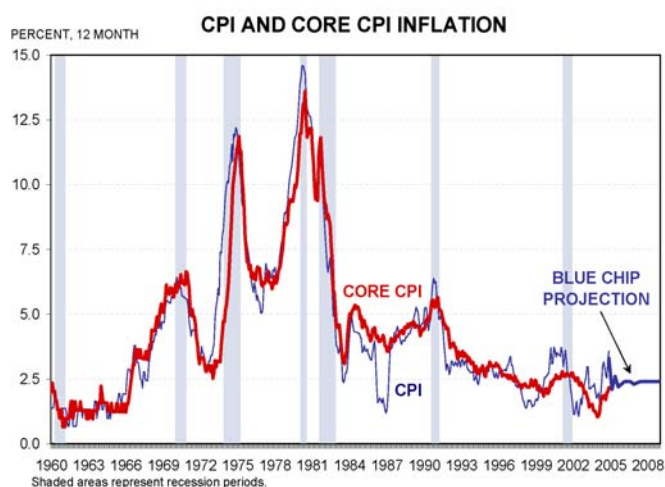
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suggested by the nominal prices (see chart below). For example, the \$40-per-barrel nominal price of crude oil that occurred in 1980 would require, in real terms, a figure exceeding \$80 per barrel in today's prices.

## Blue Chip Outlook

Private forecasters are generally optimistic about the outlook for the U.S. economy in coming years, with solid growth and low inflation expected to continue. Real GDP growth is expected to average about 3½ percent during 2005, and 3.3 percent during 2006 (see table). Those rates are just above the expected "potential" real growth rate for the economy of just over 3 percent. (The potential real growth is the highest sustained growth rate the economy can achieve without introducing pressures for higher inflation). The

unemployment rate is expected to drift down somewhat from its recent level of 5.4 percent, to 5.1 percent by the end of 2006. Consumer price inflation is expected to remain relatively low by historical standards (see chart). Interest rates are expected to continue to rise gradually over the next 2 years. The 3-month Treasury bill rate is expected to rise from its recent level of just over 2¼ percent to 3.9 percent by the end of 2006. The 10-year Treasury note yield is expected to rise from recent levels of just over 4 percent to 5.3 percent over the next 2 years.



## Blue Chip Economic Outlook, January 2005

	2004.4	2005.1	2005.2	2005.3	2005.4	2006.1	2006.2	2006.3	2006.4
	----- Projection -----								
Real GDP Growth	3.7	3.5	3.6	3.5	3.5	3.3	3.3	3.3	3.3
Unemployment Rate	5.4	5.3	5.3	5.2	5.2	5.2	5.2	5.1	5.1
CPI Inflation	3.3	2.1	2.6	2.2	2.3	2.4	2.4	2.4	2.3
3-month Treasury Bill	2.0	2.5	2.8	3.2	3.4	3.6	3.7	3.8	3.9
10-year Treasury Note	4.1	4.4	4.7	4.9	5.0	5.1	5.2	5.3	5.3

Note: Unemployment and interest rate values for 2004.4 are actual values.

## Policy Outlook

At its most-recent policy meeting in December, the Federal Reserve's Federal Open Market Committee [FOMC] raised its target for the Federal funds rate – the key interest rate through which it conducts monetary policy – by 25 basis points, to 2¼ percent (1 percentage point equals 100 basis points). In its policy statement accompanying that action, the FOMC stated that "monetary policy remains accommodative and, coupled with underlying growth in productivity, is providing ongoing support to economic activity. . . . With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured." Those statements are consistent with the

outlook of private forecasters (see Blue Chip forecast above) that interest rates will rise at a gradual pace as the economy returns to its path of steady real growth with low inflation.

The fiscal policy outlook will be addressed in detail in key government publications over the next several weeks. The Congressional Budget Office [CBO] will release its *Budget and Economic Outlook: Fiscal Years 2006-2015* next week. The projections establish the baseline from which Congress will work in preparing the budget resolution for fiscal year 2006. The Office of Management and Budget is expected to submit the President's proposed budget for fiscal year 2006 on Monday, February 7. (The administration's economic assumptions, released in December, are nearly identical to the Blue Chip projections.)

Prepared by ..... John H. Kitchen  
Chief Economist